

PUBLIC FINANCE

Diploma stage examination

12 December 2007

MARKING SCHEME



Question 1

(a) Possible points include:

- Raising the profile of grants activity and ensuring adequate resources are assigned to it.
- The above includes clearly assigning responsibility for reviewing legislation and other information about possible new sources of grant income.
- Having a single person responsible for supervising work and applying good project management principles to it.
- Incorporating grant income into budget systems to monitor claiming for entitlement.
- All documentation concerning grant eligibility to be read by an assigned person and relevant information distributed to those who need to know it.
- Effective liaison with external audit to ensure that claims requiring external certification receive it in good time.
- Use made of internal audit to assure accuracy of data and of the systems generating it.
- Develop management information systems covering areas such as grant claims made and amounts received, time spent by staff on each application etc.
- Figures contained in claims should be supported by comprehensive working papers.
- Appropriate training should be given in claims and application compilation.

1 mark per point up to a maximum of (10)

(b) The EU structural funds aim to increase social and economic cohesion within the EU by allocating funds against three main objectives, relating to relative GDP per head, structural adjustment and modernisation of education, training and employment systems. They include the European Regional Development Fund and the European Social Fund. Steps to access funding from these funds would include:

- Identify national institutions responsible for administration of structural fund programme.
- Identify requests for tenders for project participation and prepare and submit tender.
- Commence project if tender is successful and put into place appropriate monitoring procedures.
- Submit to European Commission (EC) progress monitoring reports and evidence of appropriate expenditure as required.
- Send project evaluation reports to EC for approval.

*Up to 3 marks for discussion of structural funds;
up to 5 for steps in accessing them,
up to an overall maximum of (8)*

(c) Advantages:

- Provides an objective basis for grant allocation.
- Any judgements made in the construction of the formulae can be made explicit.
- Allows grant allocation to reflect differences in local authorities' demographic, economic, social etc characteristics.
- Can facilitate equalisation of resources available to disparate local authorities.
- Data used in formulae can be kept up to date.
- Economic to administer for both central and local government.

Conditions necessary for effective operation:

- Availability of required data at good quality, consistent standard across all local authorities.
- Development of technically robust allocation formulae.

1 mark per point up to a maximum of (8)

- (d)** The term Public Private Partnership (PPP) in its widest sense refers to collaborative activity between the public and private sectors. More narrowly it is often used to refer to arrangements which bring private sector funding into partnership arrangements between public and private sector organisations. The Private Finance Initiative (PFI) is one example of such an arrangement.

The PFI is a mechanism for funding major public sector capital investments using private capital. Private companies are contracted to design, build and often operate assets required by the public sector bodies, which make a series of revenue payments for the use of such assets over a long period. A well known example of PFI projects is the redevelopment of the Barts and The London NHS trust estate.

As suggested above, PPP is a wider concept than PFI. A common form of PPP other than the PFI is the injection of private capital into public services organisations via the sale of equity to private sector investors. For example, 51% of the equity of the National Air Traffic Services was sold in 2001 to a consortium of several airlines.

1 mark per point up to a maximum of (8)

- (e)** Traditionally many PFI projects have been 'off balance sheet'. A reported requirement by the International Accounting Standards Board that all assets involved in PFI arrangements should be shown in departmental balance sheets would, it has been estimated, inflate the Public Sector Net Debt (PSND) by about two percentage points.

In 2005 the Office for National Statistics announced that the value of the imputed finance lease loan element in PFI arrangements should be incorporated within PSND.

Either of these changes would of course, other things remaining equal, make it more difficult to maintain PSND below 40% GDP over the economic cycle.

1 mark per point up to a maximum of (6)

(40)

Question 2

(a) (i) Liquidity risk – the risk that cash will not be available when needed and that the ineffective management of liquidity (defined as cash plus borrowing facilities and/ or liquid investments) will create unnecessary costs. Key to liquidity risk management is effective cash flow management, which can identify and minimise periods when borrowing is necessary to maintain liquidity. Effective cash flow management should involve factors such as prompt collection of income, recovery of arrears, managed payments to creditors and appropriate investment of surplus cash. 5

(ii) Inflation risk primarily affects fixed rate borrowing and investment (although it impacts to some extent upon variable rate borrowing via its impact upon the real value of the principal repaid). Higher than expected rates of inflation (NB expected inflation is taken account of within the market rate of interest) reduce the real value of interest payments and principal repayments, thus benefiting borrowers and harming investors. Consequently the downside risk primarily impacts investors in fixed rate instruments. A main means of addressing inflation risk is via the purchase of index linked bonds, frequently issued by government. These have their interest and principal payable adjusted each year to take account of inflation. 6

(iii) This refers to the risk of default by organisations which have borrowed from public sector organisations. The CIPFA Treasury Management code of practice requires that organisations draw up a list of approved counterparties; diversifying across such counterparties would be another means of risk management. 3

1 mark per point made up to a maximum of (14)

(b) Identification of risks
Assessment of their impact
Assessment of the likelihood of their occurrence
Calculation of their expected financial impact (usually done on an expected value basis, ie multiplying the estimated financial cost of the risk by the probability of its occurrence.)
Sensitivity analysis – structured variation of the assumptions underpinning the analysis thus far yielding a different set of risk outcomes.
Development of policies and procedures to mitigate and manage identified risk, including insurance of risk, acceptance of it and outsourcing of risk-bearing activities.

½ mark for identification of each step; up to 3 marks for further discussion as appropriate, up to a maximum of (6)

(c) (i) Around 70% (as of 2004) of local authority investments are held as deposits with banks and building societies, with other major investments being in the short term money market and government bonds, both of which have relatively high liquidity. Some variation appears to exist across internal and external managers with internal managers making significantly more use of bank and building society deposits and significantly less use of government bonds, possibly because the potential price fluctuations of the latter are perceived to require greater expertise in treasury management. 4

- (ii) Government bonds are issued on a long term basis, the government recently signalling its intention to issue bonds with lives up to 50 years. If liquidity is defined as the ability to convert assets to cash quickly, this would make such bonds very illiquid. However, a well developed secondary market (ie a market where financial instruments can be traded after their initial issue) allows holders of bonds to go liquid much more quickly. However, the full definition of liquidity encompasses the ability to convert an asset into cash without the risk of significant capital loss. The fact that the bond holder may need to go liquid when interest rates in the primary market have recently risen, thus depressing prices in the secondary market, means that an element of illiquidity remains, based upon this wider definition.

6

(10)

(30)

Question 3

- (a) The theory of Baumol's disease would suggest that improvements could be generated by investments that make government funded provision more technologically progressive; this would increase labour productivity and tend to reduce the growth of the unit labour costs of such provision. However, one would need to monitor the effect of introducing more technology into such provision upon the quality/effectiveness of service delivery. 3

Secondly, supply side theory would suggest that this could be achieved by the extension of commercial incentives to efficiency and effectiveness, such as the extension of profit motives and competition. This could involve the introduction of both greater user choice and price mechanisms and similar commercial incentives as has been the case with the Payment by Results system of the English NHS. 2

Thirdly, theory suggests that weakening the power and ability of politicians and civil servants to reflect their self interested agendas and policy decisions could increase efficiency and effectiveness. This could be achieved by systems of greater accountability being introduced into both the civil service and parliament. 2

1 mark per point, up to the maxima shown for each theory and an overall maximum of (7)

- (b) The main theories are as follows:

- Most developed economies are experiencing an ageing population, ie growth in the percentage of the population over 65. This has led to an increase in the demand for services such as healthcare, social services and pension provision. For example, concerning health care, it is estimated that annual health care provision costs on average six times more for a person over 65 than for one aged less than 65. 3
- Economic theory suggests that some public sector provision consists of 'luxury goods', ie goods whose demand grows more than proportionately as a country's income grows, eg education. Consequently, as national income grows over time demand for such provision grows significantly. 2
- Most countries experience urban development over time; it is held that this can lead to increased demand for public expenditure to counter its side-effects such as increased crime and the effects of more congested living space. 2
- The theory of 'fiscal illusion' suggests that voters underestimate the cost of public provision either because they do not understand the complex tax system or because some of the tax they pay is 'hidden', eg VAT. This is compounded by much public provision being subsidised or free at point of use. Underestimating the cost of public sector provision leads to people voting at elections for parties with more generous expenditure plans than would have been the case had they appreciated the true costs of provision. 3

1 mark per point, up to the maxima for each theory and a maximum of (10)

- (c) (i) Other things remaining equal, reduced long term borrowing by government should lead to downward pressure on domestic interest rates. This in turn is likely to lead to:
- Increased borrowing and reduced saving, increasing expenditure; this will tend to lead to increased levels of economic activity generally impacting upon output, income and employment. Inflation may also rise as a result of increased economic activity and higher levels of employment.
 - Reduced domestic interest rates will tend to reduce inward financial investment, thus reducing the demand for sterling; this will lead to a currency depreciation making imports more expensive and exports cheaper. This is likely to improve the balance of payments and further encourage economic activity. (Although the effect may be mitigated by increased inward physical investment as a result of the increased economic activity.)

5

- (ii) Reduced rates of income tax are, according to supply side theorists, likely to reduce the disincentive effects of the tax upon the desire to work hard to gain promotion or work overtime and to reduce the incentive to emigrate to more favourable income tax regimes. In addition, reduced rates of income tax are likely to reduce the automatic stabilisation effect of income tax.

3

1 mark per point up to a maximum of (8)

- (d) Achievement of the golden rule, ie that the government's current budget is in balance or surplus over the economic cycle, might appear to remain unaffected since it is concerned only with government short term borrowing. However, one could argue that reduced long term borrowing will, ceteris paribus, lead to reduced long term debt and correspondingly reduced interest payments by government to service that debt. This would reduce that element of current expenditure by government facilitating the keeping of the golden rule. Reduced long term borrowing means less growth in Public Sector Net Debt (PSND) which makes the sustainable investment rule, ie that PSND should remain below 40% Gross Domestic Product over the economic cycle, easier to achieve.

1 mark per point up to a maximum of (5)

(30)

Question 4

- (a) Road space is a scarce commodity; currently it is provided free at point of use, which according to economic theory is likely to lead to excess demand for it. Consequently charging for road space is a means of rationing demand. A further rationale for charging is the fact that driving on the roads generates negative externalities (eg exhaust fumes). While this could be countered by taxation to make the polluter pay (eg road tax, excise duty on fuel etc) road charging offers more opportunity to relate the amount paid to the extent of usage. Finally, of course, road pricing can produce a significant stream of revenue that can be used, if desired, to fund further transport related expenditure.

1 mark per point up to a maximum of (5)

- (b) Public goods have two characteristics, which are:
- Non-excludable, ie use by one person does not exclude use by others.
 - Non-depletable, ie use by one person does not deplete the amount of benefit available to others.

It is agreed that this may lead to an incentive to be a 'free rider' ie people may refuse to pay charges for such services knowing that failure to do so would not lead to exclusion from or depletion of benefit. Consequently, any price based attempt to raise revenue for the provision of such products is likely to lead to a financial shortfall and/or undersupply.

1 mark per point up to a maximum of (5)

- (c) Redistribution - this rationale seeks to respond to the perception that an unequal distribution of income and wealth is generating unfair economic outcomes. Government activity within this rationale, which involves taxation, includes:
- Provision of some goods and services, proportionately bought in greater quantities by poorer people, on a subsidised basis or free at point of use - typically financed by taxation.
 - Implementation of taxes upon income, wealth etc., which are progressive, ie the proportion of the tax base paid as tax increases as the tax base itself increases, eg income tax.

Stabilisation of fluctuating economic activity is an additional rationale for government intervention via taxation.

Increases in tax receipts during economic upswings and declines during economic downturns contribute to the stabilisation of economic activity, along with corresponding movements of government expenditure in the opposite directions.

This stabilisation effect of taxation is accentuated by progressive income tax structures.

Prior to 1979 this automatic stabilisation policy was augmented by discretionary policy involving changes in tax rates to assist stabilization, but this was discontinued because it was impossible to target the timing of the changes with sufficient precision.

1 mark per point up to a maximum of 5 for each rationale and up to an overall maximum of (10)

- (d)** Efficiency: an efficient tax is a tax which minimises its effects upon people's choices and behaviour. As is well documented, income tax, at least when levied with high marginal rates of tax, has been considered to be inefficient by supply side economists, who see such rates as generating a disincentive to work.

Equity: this can be defined in two ways:

- Equity in relation to means – the more progressive an income tax structure is the more it scores well against this criterion.
- Equity in relation to benefits received – in the absence of hypothecation it is hard to evaluate income tax against this criterion. However, generally, as many benefits from and elements of government provision are received disproportionately by those on low incomes, income tax scores poorly against this criterion.

Simplicity and low administration cost: this includes both administrative costs for government and compliance costs for others; income tax would score generally moderately, but (nb) compliance costs fall on both employers via PAYE and employees and the self-employed via self assessment.

Certainty, ie people can forecast their tax liability in different circumstances with a high level of confidence with fairly small predictable changes in allowances with marginal rates, income tax performs quite well here.

Up to 2 marks for each criterion/sub-criterion up to a maximum of (10)

(30)